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## Complying With MiFID 2: Best Execution

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MiFID 2 will bring significant changes to the way in which firms conduct their trading business and the policies and procedures they have in place for informing clients and evidencing compliance. This article looks at the changes MiFID 2 makes to best execution requirements and the changes firms will need to make to comply with MiFID 2's standards.

### What does MiFID 1 require?

MiFID 1 requires (Article 21) that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients, taking into account:

- price;
- costs;
- speed;
- likelihood of execution and settlement;
- size;
- nature; or
- any other consideration relevant to the execution of the order.

Firms are, though, expressly permitted to follow specific client instructions.

MiFID 1 requires firms to establish and implement effective arrangements for complying with these requirements—in particular each firm must have an order execution policy to allow them to obtain the best possible result for client orders in accordance with the factors listed above. The policy needs to include, for each class of investments, information on the different venues on which the firm executes orders and factors that affect its choice of venue. The MiFID Level 1 text states “it shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible results for the execution of client orders.”

Firms also need to provide appropriate information to their clients about their order execution policy and get prior consent of clients to it. The precise form of information is not mandated, but, if a firm's policy allows client orders to be executed outside a regulated market or a multilateral trading facility (MTF), the firm must tell the client and obtain the client's prior express consent before proceeding to execute their orders outside a regulated market or an MTF. Investment firms may obtain this consent either in the form of a general agreement or in respect of individual transactions.

MiFID 1 also includes a requirement on firms to monitor the effectiveness of their order execution arrange-

ments and execution policy in order to identify and, where appropriate, correct any deficiencies. It specifies that they should regularly assess whether the execution venues included in the order execution policy provide for the best possible result for the client or whether they need to make changes to their execution arrangements. Firms must notify clients of any material changes to their order execution arrangements or execution policy.

Firms also must be able to demonstrate to their clients, at their request, that they have executed their orders in accordance with the firm's execution policy. MiFID 1 required the Commission to make implementing measures (which it did in the MiFID 1 Implementing Directive) on:

- the criteria for determining the relative importance of the different factors that may be taken into account for determining the best possible result taking into account the size and type of order and the retail or professional nature of the client. The Commission said these should be:
  - o the characteristics of the client including the categorisation of the client as retail or professional;
  - o the characteristics of the client order;
  - o the characteristics of financial instruments that are the subject of that order; and
  - o the characteristics of the execution venues to which that order can be directed.

It notes an execution venue can be any of a regulated market, MTF, systematic internaliser or market maker or other liquidity provider. It goes on to specify that where the client is a retail client, firms should work out the best possible result in terms of the total consideration, representing the price of the financial instrument and the costs related to execution, including all expenses incurred by the client which are directly related to the execution of the order (such as execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order). For the purposes of delivering best execution where there is more than one competing venue the firm could use, it should take into account its own commissions and costs for executing the order on each of the eligible execution venues. Firms should not structure or charge their commissions in such a way as to discriminate unfairly between execution venues;

- factors that may be taken into account by an investment firm when reviewing its execution arrangements and the circumstances under which changes to such arrangements may be appropriate. In particular, the factors for determining which venues enable investment firms to obtain on a consistent basis the best possible result for executing the client orders. Firms should also carry out a review if there is any material change that will affect the firm's ability to continue to get the best possible result for client order execution on a consistent basis using the venues included in its policy; and

- the nature and extent of the information to be provided to clients on their execution policies. The Implementing Directive requires firms to provide to retail clients, in durable medium and in good time before providing the relevant service:
  - o an account of the relative importance the firm assigns to the relevant factors or the process by which the firm determines the relative importance of those factors;
  - o a list of the execution venues on which the firm places significant reliance in meeting its obligation to take all reasonable steps to obtain on a consistent basis the best possible result for the execution of client orders; and
  - o a clear and prominent warning that any specific instructions from a client may prevent the firm from taking the steps that it has designed and implemented in its execution policy to obtain the best possible result for the execution of those orders in respect of the elements covered by those instructions.

### What Does MiFID 2 say?

MiFID 2, in its recitals:

- confirms the need for an effective best-execution obligation to ensure that investment firms execute client orders on terms that are most favourable to the client. It states this obligation should apply where a firm owes contractual or agency obligations to the client;
- notes that because there is now a wider range of possible execution venues, and advances in technology, there is a need to enhance the best execution framework for retail investors and consider how to apply it;
- specifies that, when determining best execution when executing retail client orders, the costs relating to execution should include an investment firm's own commissions or fees charged to the client for limited purposes, where more than one venue listed in the firm's execution policy is capable of executing a particular order. The relevant costs relating to execution on each of the eligible execution venues should be taken into account in order to assess and compare the results for the client of using each potential venue. The Commission made it clear, though, that this did not mean firms would need to assess potential results on the hypothesis of the client taking a different service package from the firm or it offering other fee bases or if the client used a different firm;
- says the amount of a firm's own commissions or fees charged to the client for the provision of an investment service should not apply for the purpose of determining what execution venues should be included in the firm's execution policy;
- comments on the prohibition on firms structuring or charging commissions in a way which discriminates unfairly between execution venues if it charges a dif-

ferent commission or spread to clients for execution on different execution venues and that difference does not reflect actual differences in the cost to the firm of executing on those venues;

- explains that it is important to make available to the public data relating to the quality of execution of transactions on each venue;
- comments that information provided by investment firms to clients in relation to their execution policy is often generic and standard and does not allow clients to understand how an order will be executed and to verify firms' compliance with their obligation to execute orders on terms most favourable to their clients. In addition to mandating how firms should prepare and communicate their execution policy it says firms should also, for each class of financial instruments, publish the top five execution venues where they executed client orders in the preceding year and to take account of that information and information published by execution venues on execution quality in their policies on best execution; and
- notes that when a firm is establishing the business relationship with the client it might ask at that time for consent to the execution policy as well as to the possibility that that person's orders may be executed outside a trading venue.

These recitals are reflected mainly in Articles 24 and 27 of MiFID 2. The overarching requirements on information to clients (discussed also in other articles in this series) are set out in Article 24 and include that appropriate information shall be provided in good time to clients or potential clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges.

Article 27 deals with the obligation to execute orders on terms most favourable to the client. The key terms state that:

- Member States shall require that investment firms take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account:
  - o price;
  - o costs;
  - o speed;
  - o likelihood of execution and settlement;
  - o size;
  - o nature; or
  - o any other consideration relevant to the execution of the order.

But firms should nevertheless execute orders in compliance with any specific instruction a client gives.

- Where the client is a retail client, firms should determine the "best possible result" in terms of the total consideration, which is the price of the financial instrument and the costs relating to execution, including all expenses incurred by the client directly relating to the execution of the order.
- Where there is more than one possible venue listed in the firm's order execution policy that is capable of executing a particular order, the firm should take into account its own commissions and the costs for executing the order on each relevant venue.
- A firm may not receive any remuneration, discount or non-monetary benefit for routing client orders to a particular trading venue or execution venue which would infringe MiFID 2's requirements on conflicts of interest or inducements.
- Where financial instruments are subject to the trading obligation in MiFIR each trading venue and systematic internaliser (and for other financial instruments each execution venue) must make publicly and freely available, at least annually, data relating to the quality of execution of transactions on that venue on at least an annual basis. Firms must inform clients where each order is executed and must also provide periodic reports to clients including details about price, costs, speed and likelihood of execution for individual financial instruments.

Firms are to establish and implement effective arrangements for complying with these requirements, particularly an order execution policy to allow them to obtain, for their client orders, the best possible result. The order execution policy is to include, in respect of each class of financial instruments, information on the different venues where the firm executes its client orders and the factors affecting the choice of execution venue. It shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders. Firms must provide appropriate information to their clients on their order execution policy, that explains clearly, in sufficient detail and in a way that can be easily understood by clients, how orders will be executed by the investment firm for the client, and must get prior consent of their clients to the order execution policy. Where orders may be executed outside a trading venue, clients should be warned, and their prior express consent obtained before any orders are so executed. The consent can be general, or specific to a given transaction.

Firms must then:

- summarise and make public on an annual basis, for each class of financial instruments, the top five execution venues in terms of trading volumes where they executed client orders in the preceding year and information on the quality of execution obtained;
- monitor the effectiveness of their order execution arrangements and execution policy to identify and, where appropriate, correct any deficiencies. The monitoring should include regular assessment of whether the execution venues in the policy provide

for the best possible result for the client or whether changes are needed. In making the assessment, firms should look at the relevant published data on the venues. If they make a material change their order execution arrangements or execution policy they should notify clients with whom they have an ongoing client relationship; and

- be able to demonstrate, if clients ask, that they have executed their orders in accordance with their execution policy and to show the regulator, on request, that they have done so.

MiFID 2 allows the Commission to adopt delegated acts on:

- the criteria for determining the relative importance of the different factors that may be taken into account for determining the best possible result taking into account the size and type of order and the retail or professional nature of the client;
- factors that may be taken into account by an investment firm when reviewing its execution arrangements and the circumstances under which changes to such arrangements may be appropriate. In particular, the factors for determining which venues enable investment firms to obtain on a consistent basis the best possible result for executing the client orders; and
- the nature and extent of the information to be provided to clients on their execution policies, pursuant to paragraph 5.

It also mandated ESMA to develop draft regulatory technical standards (RTS) for the Commission to approve, to determine:

- the specific content, the format and "periodicity" of data relating to the quality of execution, taking into account the type of execution venue and the type of financial instrument concerned; and
- the content and the format of information to be published by investment firms.

### Commission and ESMA Work

As previous articles have noted, the MiFID 2 implementation timetable is running late. ESMA was to advise the Commission on delegated acts by the end of 2014, and the Commission was to adopt the delegated acts six months later. ESMA was to publish draft RTS by the end of July 2015, and the Commission was to adopt it three months later. To date, the Commission has finalised nothing.

### ESMA's Technical Advice

ESMA had advised the Commission that many of the provisions of the MiFID1 Implementing Directive discussed above remain appropriate. It suggests the following changes:

- that policy information be customised depending on the class of instrument and the service provided. Firms should include in the information to clients the

list of factors they used in their choice of venue and the relative importance of each. The explanation should consider qualitative factors and explain how all factors are considered as part of the overall determination on best possible client results. Also, ESMA said the information should summarise how venue selection occurs, specific execution strategies used, procedures and processes used to analyse the quality of execution obtained and how the firm monitors and verifies that it did get the best results for its clients;

- that firms need to set out for clients which venues or entities they use for execution and for which instruments;
- that information on determinative factors should be consistent with the controls the firm uses to show it consistently achieves best execution and when it is reviewing the adequacy of its policies and arrangements;
- that firms be permitted to gather market data used in estimating pricing for executing OTC and bespoke products, comparing them with similar products where possible;
- to require firms to answer clearly and within a reasonable time client requests about the information they receive;
- that firms must clearly indicate, where it is the case, when they execute, or transmit or place orders with an entity that may execute them outside a trading venue, so the client can have the opportunity to ask further questions. This information should also set up the consequences of counterparty risk to the client where execution happens in this way;
- to clarify that, while prior express consent is not needed for firms transmitting or placing orders that may be executed outside a trading venue, clients must have appropriate information about the relevant entities on their request;
- in respect of the content of disclosures, that information should be presented in a way to make it possible for clients to understand the advantages and disadvantages of one venue over another in cases where the fees depend on the venue or entity. The firm must be fair, clear and not misleading in any information it presents to the client asking the client to choose the venue, and should prevent the client choosing a venue on the basis of cost alone;
- in respect of third party payments, firms must clearly include in their policies the circumstances in which they will receive any permitted inducements, including information on fees charged. The client must also be aware of the value of any benefit the firm receives if it is permitted to charge more than one participant in a transaction;
- in respect of factors that may be a material change, this would be a significant event of an internal or external nature that could impact the parameters of best execution. Firms should, in respect of any such

change, assess whether it needs to change the relative importance of the best execution factors or to change the venues or entities on which it relies to provide execution;

- where a firm includes a single execution venue only, it needs to have a reasonable expectation the single venue can get results at least as good as could reasonably be expected from alternative venues or entities. It must support this view with relevant data, information or analysis; and
- where firms do not themselves execute orders, they should publish, at least annually, for each class of instruments, the top five firms in respect of trading volumes where they placed orders, and information on the quality of execution obtained.

## The RTS

The RTS, which ESMA submitted to the Commission (with many others) at the end of September 2015, proved controversial during consultation. ESMA adapted its original draft in light of responses to address concerns on scope, and on quantity of reportable data. It also made a change to confirm that information on professional client orders should not be mixed with that on retail client orders. Two RTS cover, respectively:

- information on execution data: this (RTS 27 in ESMA's September 2015 publication) applies to trading venues, systematic internalisers, market makers and other liquidity providers and sets out the information each venue must publish in terms of general information, price, costs, likelihood of execution (i) for each instrument subject to the MiFIR trading obligation and (ii) for each market segment. It also sets out what additional information is required for continuous auction order book and continuous quote-driven execution venues and for request for quote execution venues. The RTS also address how to determine reporting ranges, and include templates for publishing the information, mandating the templates be completed in machine-readable electronic format that the public can download, and require the information be published four times a year and no later than three months after the end of each quarter; and

- annual publication by investment firms of information on the identity of execution venues and on the quality of execution: this (RTS 28 in ESMA's September 2015 publication) applies to investment firms in relation to client orders executed on trading venues, systematic internalisers, market makers, other liquidity providers, or third country equivalents. It mandates the form in which these firms must publish required information on the top five execution venues and quality of execution obtained. The RTS differentiate between orders for retail and professional clients, and between those orders that are securities financing transactions and those that are not.

## Likely Changes to FCA Rules

FCA's rules on best execution are set out in Chapter 11.2 of its Conduct of Business Sourcebook (COBS). Clearly this will need to be updated, and more prescriptive requirements introduced, to take account of MiFID 2. Essentially, as is the case with certain other parts of MiFID 2, the message from ESMA has been that much of MiFID 1 was not really broke, so rather than ripping it up and starting again to fix it, it is more a case of building the new protections and increased information requirements into the existing framework. FCA had hoped to have consulted on the necessary rule changes by now, but cannot to do until the Commission publishes the Level 2 legislation and endorses ESMA's RTS. However, the prescription of the Level 1 text is enough to help firms identify where they will need to make the most changes to their policies and procedures, so they can start planning for implementation. While many of the changes will lead to increased burden in information gathering and reporting, some are more wide-ranging, such as the impact of the MiFID 2 restrictions on inducements and conflicts. Firms will need to assess how their charging structures will comply with MiFID 2, and how to factor in costs when complying with its best execution requirements.

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